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Alaska REAL ESTATE BY DAVE WINDSOR

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INCOME PROPERTY - ANALYZING YOUR INVESTMENT

Many people become excited, from time to time, about becoming a Landlord. The idea of owning extended real estate assets beyond your own home is a good one, provided it suits your overall long-term financial goals.

Before putting your money down, however, it is important to analyze the investment and determine whether you would be better off just putting your spare cash in a Certificate of Deposit at your favorite bank.

In this article, we will talk about 3 commonly used formulae for measuring the value of an income property, be it a duplex, fourplex or a 10-apartment complex.

As we define the 'Gross Rent Multiplier' (GRM), the 'Capitalization Rate' (Cap Rate) and 'Cash on Cash Return' (CCR) we must also watch out for the 'Apples and Oranges' problem. There are other differences between properties besides the numbers, the main one being that while a duplex, triplex and fourplex may be considered together, anything above 4 units in a property is a completely different animal. This will become clear as we proceed.

Gross Rent Multiplier:

This is the simplest way to compare one 'apple' with another 'apple', but not an 'orange'. The GRM is the number of times that the Gross Rent for a whole year divides into the Purchase Price.

Thus, if a Triplex costs $300,000 and brings in gross rent of $30,000 per annum, the GRM = 10. If you were comparing this to a Fourplex at $400,000, bringing in $36,400 a year, that GRM would equal 11. The Fourplex is priced higher than the Triplex according to its GRM because the Seller wants 11 times the annual rent versus the Triplex at only 10 times the annual rent.

The GRM is a good rule of thumb, not for establishing fundamental value, but for comparing like kind properties. You can use the GRM to compare duplexes, triplexes and fourplexes with each other. They are all 'apples'.

You could also use GRM to compare any complexes with 5 or more units. They are all 'oranges'. The GRM is a "Comparison" tool only, not a measure of value per se.

Why are Apples and Oranges Different?

Income properties up to a fourplex, and this also includes any single family home you might buy as an investment, are all EASILY FINANCED. You can see your regular lender and FHA, VA and Conventional options exist with small downpayments.

'Oranges', however, (i.e. 5 and above units) fall outside traditional lending products. In effect, you are looking for Commercial Financing, much as you would if you were starting a business. This involves seeing a Bank to arrange commercial financing. There are products, with as little as 20% down, available commercially. The best is the Alaska Housing Multi-Family program (AHFC).

As we move on here keep in mind that, besides financing, there can be many other differences between 2 Apples also, or between 2 Oranges. No matter what the numbers say, you may prefer to own your fourplex in Spenard, where you are near your own home and close to the Airport, rather than Mountain View.

Properties can also vary in the degree of 'Deferred Maintenance'. One may be in excellent condition, and the other in poor condition but on the Downtown Park Strip. Relative appreciation prospects may be greater on the 'poor condition' downtown unit compared to the other property in great shape.

So let's move on - - -

Capitalization Rate:

Now we are becoming more like accountants. The Cap Rate is the Net Operating Income (NOI), before allowing for Debt Servicing (i.e. your loan repayments), as a percentage of the Purchase Price. (i.e. What is the rate of return on the Capital Investment?)

Let's take an 8-plex priced at $500,000. Gross Rent is $80,000 and there is $2,400 also derived from the coin operated laundry. Deduct an allowance for Vacancies (i.e. empty units from time to time) - 5% is a good rule of thumb unless you can measure accurately based on the past. Gross Income is, therefore, $80,000 plus $2,400 less $4,000 = $78,400.

Expenses must include Property Taxes, Insurance, any Utilities paid by Owner, Water & Sewer, Trash Pickup, Ground Maintenance, Property Management (if any - usually costs between 6% and 8% of rents if you want to hire it out) and, lastly, Maintenance - a difficult figure to project, but use 5% of Rents as a rule of thumb.

Let's say expenses total $35,000. NOI is, therefore, $78,400 less $35,000 = $43,400 - - - - or 8.68% of the Purchase Price of $500,000. This is the Capitalization Rate: 8.68%.

Most professional investors would see a Cap Rate below 8% as totally unacceptable. 8.68% would not be so bad, particularly if the property was in good condition, easily rented, and had good prospects of appreciation. A Cap Rate of 10% to 12% would be very tempting.

Unlike the GRM, you can do a Cap Rate on a Duplex, Fourplex, and the above Eight-plex, because it shows you a strict rate of return. Generally, you will find that a Fourplex produces a much better Cap Rate than a Duplex. As you add units above 4, provided you can obtain the financing, the Cap Rate will tend to improve even further.

By now, you will also realize that there are THREE expenses that can make or break your operation:-

First is the vacancy factor. Can you keep the units full, and will you have to evict tenants for not paying? Secondly, how much will maintenance cost? A thorough inspection before buying is critical to help you estimate what you will need for maintenance. If you do the work yourself, it will obviously cost less.

Third is the question of whether you hire a Property Manager. This costs a significant slice of your rental income but can work out on complexes of 8 or more units. You may even do a deal with someone who occupies the property, rent-free, in exchange for collecting rents and doing minor maintenance.

Cash on Cash Return:

The CCR tells you how much cash in pocket you will receive as a percentage of the cash you need upfront to acquire the property. The CCR makes a lot of simple sense to most people. If you have to find $60,000 total (including closing costs) to acquire your fourplex, and you will have a positive cash flow (before Income Tax) of $6,000 at the end of the year, you are making a 10% return, Cash on Cash.

It is easy to calculate your Cash Investment once you have seen your Lender and Realtor. Add all the cash you will need to buy the property: Downpayment, Closing Costs, Inspection Fees etc. This is your 'Cash In'.

Your Cash Return (before Income Tax) is the Net Operating Income, previously discussed, less one other cash outflow not included there - - - can you guess?

You must further reduce the NOI by your repayments to the Bank!

Your Gross Income, less your Expenses, less your Debt Service Cost = your Cash Return. The Cash on Cash Return really wants to be at least 10%. 15% is excellent, 20% is a no-brainer!

WARNING! There are many Realtors and Sellers floating around who quote Cap Rates or CCR's that are absolutely wrong! Persons improperly trained have no idea what these numbers mean. Numbers can also be misstated. A basic Real Estate Licensee has NO TRAINING WHATSOEVER in these analysis techniques.

I can help you with your investment decisions. You should also consult your CPA to discus the Tax implications of your investments.

Good Luck! I hope this has been helpful, and please feel free to call any time.

Dave Windsor